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Russia: The road to ruin

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Abstract:

*As Russia turns its back on reform, the recriminations begin about who is to blame. **Jeffrey Sachs**, who resigned on January 21, 1994, as an advisor to the Russian government, blames the West and particularly the International Monetary Fund (IMF) for failing to support the reformers. The IMF believes that more could have been done by the reformers, but was not. The achievements and missed opportunities of 6 distinct phases are considered: 1. before August 1991: Was the inheritance too crushing?, 2. August 1991-January 1992: Did the reformers waste their first opportunity?, 3. June 1992-March 1993: Did Boris Yeltsin fail the reformers?, 4. March 1993-September 1993: Why was the deadlock not resolved?, and 6. September 1993-December 1993: Why did the election go wrong?. After a series of short-lived and fractious coalitions, Russia now has a united government dominated by industrial lobbies. There remains no obvious figure with the power to block their pleading to slow reform.*

Full Text:

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As Russia turns its back on reform, the recriminations being about who is to blame. Jeffrey Sachs, who resigned on January 21st as an adviser to the Russian government, condemns the West and particularly the International Monetary Fund (IMF). The purpose of aid to Russia, insists Mr Sachs, should be political: to keep reformers in power. The West failed to support the reformers, and lost them. The IMF, which prefers economic criteria, argues that the Russian government made promises that it failed to keep.

However the West may have failed Russia and itself, Mr Sachs's version of events, and the IMF's, both rely on views of the Russians' own behaviour. Mr Sachs believes that the reformers did what could reasonably have been expected of them. The IMF believes that more could have been done, but was not. To decide who is right, consider the achievements and missed opportunities of six distinct phases.

* **BEFORE AUGUST 1991. WAS THE INHERITANCE TOO CRUSHING?** Even by post-communist standards, Russia came with an unusually difficult economic legacy. The reformers inherited a budget deficit running at 31% of GDP, foreign-exchange reserves down to three hours-worth of import cover, and a collapse of trade with Soviet republics. The industrial base was hue and loss-making. Monopolies choked the economy. Nothing had been done to reform agriculture, a central failure of Mikhail Gorbachev's.

Largely because Mr Gorbachev had not believed in the market economy, his own attempts at reform were counterproductive. By August 1991, he had reviewed and rejected 13 reform programmes, including the radical "500-day" plan of September 1990. Mr Gorbachev's record was one reason why western analysts were not more readily enthusiastic about Boris Yeltsin: they had already seen too many Russian reform plans come and go.

Even then, the economy was by no means the worst of Russia's problems. The country faced a humiliating retreat from empire both in Eastern Europe and in the former Soviet states; and it needed to build a democracy from scratch without any of the tradition on which, say, the Czech Republic could draw. It also had to do all this without functioning government, because, more so than other Soviet republics or the East European satellite states, Russia had little in the way of government machinery separate from that of the Soviet Union. When Soviet power collapsed, Russia had nothing.

For all these reasons, reform in Russia was always going to be harder than anywhere else. But that did not mean it was doomed from the start. Reform can thrive on crisis, when crisis provides opportunities for decisive action by small, determined groups. At the start, Russia did have a small group of people with a clear idea of what to do (though divisions quickly emerged among them). They retained popular support for a surprisingly long time. As late as September 1992, half the population wanted reforms to be speeded up.

* **AUGUST 1991-JANUARY 1992. DID THE REFORMERS WASTE THEIR FIRST OPPORTUNITY?** In principle, all reformers' freedom of action is greatest at their moment of taking office, because harsh decisions can then be blamed on their predecessors. But Russia's dire inheritance limited opportunities from the outset. Ideally, in the view of Grigory Yavlinsky, who had helped write the 500-day programme for Mr Gorbachev, the dismantling of monopolies should have come before the liberalising of prices. But with the central-planning system in collapse, price liberalisation could not be delayed.

Partly because of this, and partly because some of the reformers were less keen than others, the first Yeltsin team failed to make the most of its early opportunities. It refused to free energy prices, ensuring both that oil output would continue to fall and that the decision to raise prices later would be politically more difficult. It allowed local authorities to maintain some price controls, limited mark-ups in state shops, and resisted full opening to foreign trade.

But in the circumstances, it is surprising just how much the early government did achieve. It freed most prices without riots, sharply reduced shortages and, by cutting the budget deficit, hauled the country back from the edge of hyperinflation.

There is a strong case, in fact, for saying that the reformers' crucial early error was a political one: they would have been far cleverer to have secured new parliamentary elections at once, not two years later amid falling living standards and intense political wrangling. But in August 1991, Alexander Rutskoi

and Ruslan Khasbulatov, who were to lead parliament's insurrection two years later, were standing shoulder to shoulder with Boris Yeltsin on the balcony of the White House celebrating Russia's victory over Soviet communism. In early November parliament granted Mr Yeltsin emergency powers to introduce reform by decree. At that point the government seemed to have all the means it needed.

Nor would an early election alone have resolved what became Russia's biggest political problem of 1992-93: the constitutional chaos created by an uncertain division of powers between parliament and president, which set both camps fighting for control over monetary, fiscal and industrial policy. To have pre-empted that development would have required a new constitution as well as a new parliament--a tall order in Russia's first few months as an independent state.

It can be argued, therefore (as Mr Sachs makes a good job of doing), that the Russian reformers did as much in the early months as could reasonably have been expected of them. They might have done much better still with western aid--but they did not get it. Teams of bureaucrats descended on Moscow in the winter of 1991. Their decisions were dreadful.

The IMF wrongly advised the Russians not to set up a separate currency, advice that later cost Russia 10% of its GDP as other republics issued rouble credits that Russia felt obliged to cover. It also insisted, wrongly, that Russia did not need balance-of-payments support, though imports had dropped by 45% in 1991. Advisers from the G7 group of leading economies meanwhile seemed simply to ignore the astonishing shift in Russian economic policy, and focused instead on Soviet foreign debt, insisting that the new government should hand over its last kopek's-worth of foreign exchange in debt service. No one seriously discussed economic stabilisation. "Aid" in those days meant food parcels.

In April 1992, as the danger of missed opportunity became palpable, George Bush announced \$24 billion in aid. Even this failed to arrive. Of its central element, \$4.5 billion due to come from the World Bank and IMF, the bank lent \$670m but did not disburse it until 1993. The IMF's standby arrangement was not approved until August, when the fund lent \$1 billion on condition that the money be held in reserves, not spent. For the rest, the Bush package consisted of short-term loans at market interest rates which helped exporters to Russia at a high cost to the Russian budget.

* JUNE 1992-MARCH 1993. DID BORIS YELTSIN FAIL THE REFORMERS? This western niggardliness took its toll in the summer of 1992. By July, Yegor Gaidar, arch-reformist and acting prime minister, had cut monthly inflation to 9%. Russia was within striking distance of stability. But the austerity policies which made that possible had also met fierce opposition from industrial bosses, who launched their own political party.

Western aid could have helped Mr Gaidar soften the impact of his policies; but the IMF loan was not then signed. Without it, he faced a dangerous confrontation with the industrialists' lobby in parliament.

Mr Gaidar decided to retreat, hoping to stay in office and so protect the fledgling privatisation programme. He bought himself a few vital months, but only at the cost of acquiescing in a soaring inflation rate. By December, he was out. Worse, he left behind him a new and profligate central-bank chairman, Viktor Gerashchenko, who was to play a leading role in undermining reform over the next 18 months. Recommending Mr Gerashchenko was Mr Gaidar's biggest mistake; his motive remains a mystery.

This first departure of Mr Gaidar raised a more fundamental question: could things have been different had Boris Yeltsin supported the reforms more forthrightly? To answer that question, take a step back.

One of the few features common to successfully reforming countries has been a leader with a clear sense of where he wants his country to go and a willingness to stick by his purpose when the going gets rough--Vaclav Klaus, or Lech Walesa, for example. In defence of Boris Yeltsin, it might be said that he was resolute in the 1991 coup; he was bold enough to promote Mr Gaidar when most of his other advisers were urging caution; and he was willing to fight for Boris Fedorov as central-bank governor rather than Mr Gerashchenko. But on balance periodic acts of strength have not outweighed Mr Yeltsin's systematic weakness.

First, Mr Yeltsin lacks a consistent view of where he wants Russia to go. In 1990-91 he was willing to settle for a Russia within the Soviet Union, albeit with increased powers. In 1991, he talked of westernising Russia, turning it into a liberal democratic state. Now, he is talking about reviving a strong Russian state. While Mr Klaus relentlessly pursues membership of the European Union for the Czech Republic, Mr Yeltsin's trimming reflects something of Russia's Eurasian ambivalence.

Second, though willing to show courage in a crisis, Mr Yeltsin has failed to provide the steadier and more sustained leadership that would have enabled reformers to survive at other times. To do this, short of imposing authoritarian rule, Mr Yeltsin should have organised a presidential party of reform. Here, Mr Klaus has argued, lies the new Russia's greatest political failure.

By the hot summer of 1992, Mr Yeltsin had abandoned his initial "policy of breakthrough", which had meant acting as his own prime minister and putting himself in the front line of reform. Instead, he reacted to parliament's attacks on his policies by trying to stay above the fray, bringing an industrialist into government here, slipping a reformer back there, more like a feudal monarch than a modern head of state.

Worse, he attempted to bypass parliament by setting up rival centres of power, giving increased authority to his own entourage and to a body called the security council which had ill-defined but wide-ranging powers. He did this for fear that he himself might be brought down by attacks on his reforms. But he succeeded only in worsening the constitutional muddle inherited from the Soviet system, producing by the winter of 1992-93 a deadlock between president, government, parliament and central bank.

* MARCH-SEPTEMBER 1992. WHY WASN'T THE DEADLOCK RESOLVED? Even some of Mr Yeltsin's closest advisers were not sure what he was going to say when he went on television on the evening of March 20th 1993. The parliamentary session, just ended, had severely trimmed his powers. Nothing had been done to give any fresh impetus to reform, and some past gains were eroding. By the beginning of 1993, monthly inflation, at 27%, was soaring again.

Against this grim background, Mr Yeltsin's resolution reasserted itself. He declared that on April 25th there would be a vote of confidence in his performance.

Pessimists argued that regional opposition would block the referendum, or that no one would bother to vote. Even Mr Yeltsin's new prime minister, Viktor Chernomyrdin, thought a majority would vote against the president's economic policies. They were wrong. Nearly 60% of voters backed Mr Yeltsin, and 53% backed his economic policies. Yes votes carried 66 of Russia's 88 provinces and republics, destroying the claim that swathes of Russia were anti-Yeltsin.

The referendum gave Mr Yeltsin the freedom to tilt the balance of power in government against the

conservatives brought in by Mr Chernomyrdin; and in favour of Mr Fedorov, by then the finance minister, and of Anatoly Chubais, in charge of privatisation. Here was a second opportunity for breakthrough.

At first the signs looked good. The G7 promised Russia a second aid package, this time of \$28 billion. Anders Aslund, a Swedish economist who served as an adviser to Mr Fedorov in 1993, says America's policies towards Russia, steered by Lloyd Bentsen and Larry Summers at the Treasury, were now "first rate". Mr Aslund also gives the IMF, criticised by his colleague, Mr Sachs, the benefit of the doubt: "The IMF did more to support reform than most agencies--it actually lent Russia some money."

But the IMF could only be expected to support economic policies that were likely to work--which excluded Mr Gerashchenko's central bank. In July 1993, when Mr Yeltsin was on holiday and Mr Fedorov was in America, Mr Gerashchenko announced a confiscatory monetary reform. The operation was (characteristically) bungled; inflation increased.

By fighting the central bank at every step, Mr Fedorov managed to reduce the credits it handed out from 42% of GDP in the fourth quarter of 1992 to 25% in the third quarter of 1993. He abolished import subsidies, which had gobbled up 13% of GDP in 1992, and cut subsidies to other former Soviet states to under 4% by late 1993. But Russia was still missing its IMF targets.

At this point, if the purpose of aid to Russia should have been--as Mr Sachs argues--fundamentally political, then more should have come from the G7. For various reasons, it did not. Some of the G7 countries were in recession. Germany had provided half of all aid to Russia since 1991 and was unwilling to give more. Japan was locked in a dispute over the Kurile islands. So the G7 hid behind the IMF; and the Russian government added to its own problems by blocking (out of indecision) World Bank loans intended to finance social spending.

Above all, it was clear by the autumn of 1993 that fundamental reform would be impossible so long as parliament continued to vote for open-ended spending. It was parliament that forced the crisis. It tabled motions for a budget which, if adopted, would have brought hyperinflation. Then, it began to debate stripping Mr Yeltsin of his remaining powers.

* SEPTEMBER-DECEMBER 1993. WHY DID THE ELECTION GO WRONG? Mr Yeltsin launched a pre-emptive strike. On September 21st he dissolved parliament, announcing that an election for a new one, and a referendum on a new constitution, would be held on December 12th. This gave the reformers two months to rally public support.

They did too little, partly because the April referendum had lulled some into thinking that people would support them come what may. Others gaily assumed that the self-interest of an emerging class of property-owners would ensure that liberal democracy followed automatically. Whatever the reason, most of the reformers campaigned miserably.

They split into four groups, with the three smaller ones treating the largest, Russia's Choice, as their main enemy. "No democratic party identified the people as its target group," says Mr Aslund. "They lectured people like old-style communists."

The one man who can claim to have campaigned as a true democrat--in the sense that he raised questions which troubled ordinary voters and supplied attractive, if insane, answers--was an extreme nationalist, Vladimir Zhirinovsky. He picked up 15m protest votes from people frustrated by all

established politicians, old-guard communists and thrusting democrats alike.

This may not have been a vote against economic reform itself. Yuri Levada, who runs a polling firm, believes that the most consistent support for Mr Zhirinovsky came from men aged 25-40, most of whom earned above-average wages. Their main concern, says Mr Levada, was law and order. Mr Zhirinovsky's core support relied much less on the unskilled, elderly and unemployed--the losers from economic reform.

If so, then the best way to counter Mr Zhirinovsky would be to continue with economic reform while cracking down on crime. The worst way would be for the Russian government and its western supporters to lose their nerve about reform and so make social disorder worse. Yet that second course is the one the government seems to have chosen, in part because of another ill-timed intervention from the West.

* JANUARY 1994. IS REFORM DEAD? During a visit to Moscow shortly after the election, Vice-President Al Gore said the IMF was being too tough in its policy advice to Russia. Strobe Talbott, Bill Clinton's main adviser on Russia, then went so far as to coin an anti-reform slogan, claiming that Russia needed "less shock, more therapy". These remarks, which came as Mr Yeltsin was pondering a new government, were a "stab in the back" for reform, says Mr Fedorov. with even America seeming to soften on reform, Mr Chernomyrdin pounced--forcing out of government all the top reformers except Mr Chubais; Mr Fedorov's departure on January 26th completed that process.

The result, for the time being at least, is that after a series of short-lived and fractious coalitions, Russia now has a united government dominated by industrial lobbies. There remains no obvious figure with the power to block their special pleading to slow reform.

This does not necessarily imply an absolute reversal of all that reform has achieved. Central planning is dead, and the private sector that has sprung up over the past two years will not be snuffed out easily. But the post-election shift does mean the end of sensible macroeconomic policies and the demise of those in government who wanted genuinely free markets. Worse, it gives power to those who believe Russia has nothing to learn from other countries. This could indeed make Russia unique if it leads to the triumph of a political madman, Mr Zhirinovsky, in the 1996 presidential election.

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